Georgia Tech Financial Analysis Lab
800 West Peachtree Street NW
Atlanta, GA 30332-0520
404-894-4395
http://www.mgt.gatech.edu/finlab

Dr. Charles W. Mulford, Director
Invesco Chair and Professor of Accounting
charles.mulford@mgt.gatech.edu

Andrew Parkhurst
MBA Student
andrew.parkhurst@mba.gatech.edu

The Financial Statement Effects of Proposed Changes to the Accounting for Direct-response Advertising Costs

For Most Firms: No Big Deal

Executive Summary

As part of its revenue recognition project, the FASB is currently evaluating proposed changes to the manner in which companies account for, and currently capitalize, direct-response advertising costs. Our study examines the potential effects of such proposed changes on total assets, shareholders' equity, financial leverage and pre-tax income. We include a total of 25 companies in our sample and use information provided in their 2008 and 2009 Form 10-K annual filings to the SEC.

Amortization periods for capitalized direct-response advertising costs are typically less than twelve months. As such, the effects of capitalization relative to the direct expensing of direct-response advertising costs are, for most firms, not that significant. We find that as a result of capitalization, companies hold on average 2.26% of total assets and 3.17% of shareholders' equity in the form of capitalized direct-response advertising costs. Though the effects for some firms exceed 20% and 28%, respectively. As to the effects on pre-tax income, depending on amounts capitalized relative to amounts amortized, some firms would see declines in pre-tax income of 30% or more. However, the effects for most firms are limited, with the average firm seeing a decrease of 3.53%. Investors and accounting regulators will want to take note of these findings.

July 2010

Georgia Tech Financial Analysis Lab

College of Management
Georgia Institute of Technology
Atlanta, GA 30332-0520

Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

Contact Information

Charles Mulford	Invesco Chair, Professor of Accounting and the Lab's Director Phone: (404) 894-4395 Email: charles.mulford@mgt.gatech.edu
Andrew Parkhurst	Graduate Research Assistant and MBA Student
Brandon Miller	Graduate Research Assistant and MBA Student
Website:	http://www.mgt.gatech.edu/finlab

Companies Named in This Report

	Page
Acco Brands Corp.	8, 10, 11
Aerogrow International Inc.	8, 9, 10, 11
America Online, Inc.	4
American International Group	8, 9, 10, 11
Brown Shoe Company Inc.	8, 10, 11
Casual Male Retail Group	8, 9, 10, 11
Cross Country Healthcare Inc.	8, 10, 11
CUC International, Inc.	4
Dynamic Response Group Inc.	8, 9, 10, 11
EBHI Holdings Inc.	8, 9, 10, 11
Ennis Inc.	8, 10, 11
Findex Com Inc.	6
Franklin Covey Co.	8, 9, 10, 11
Frederick's of Hollywood Group	8, 9, 10, 11
Genesco Inc.	8, 10, 11
Gymboree Corp.	8, 10, 11
Imergent Inc.	8, 9, 10, 11
Intersections Inc.	8, 9, 10, 11
J C Penney Co Inc.	8, 10, 11
J Crew Group Inc.	5, 8, 10, 11
Limited Brands Inc.	8, 9, 10, 11
Mandalay Media Inc.	6
Medco Health Solutions Inc.	6
Nutri System Inc.	8, 10, 11
Owens & Minor Inc/VA/	8, 9, 10, 11
Scotts Miracle-Gro	5, 8, 9, 10, 11
Select Comfort Corp.	8, 9, 10, 11
Staples Inc.	8, 10, 11
Starbucks Corp.	8, 10, 11
Thermo Fisher Scientific	8, 10, 11

The Financial Statement Effects of Proposed Changes to the Accounting for Direct-response Advertising Cost

For Most Firms: No Big Deal

Introduction

In this study we examine the potential effects of proposed changes to the manner in which companies account for the costs of direct-response advertising. While advertising costs are expensed as incurred, direct-response advertising costs are capitalized and subsequently amortized. This form of advertising can be characterized as being designed or intended to elicit a direct-response from the consumer which can be measured or quantifiable. The potential effects of the proposed changes are broad, and include impacts to pre-tax income, total assets, and shareholders' equity.

Statement of Position (SOP) 93-7 deals with the subject of advertising costs. The Statement defines direct-response advertising costs as meeting two conditions:

1) The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising.
2) The direct-response advertising results in probable future benefits.[1]

Because they result in probable future benefits, direct-response advertising costs meet the definition of an asset, permitting the capitalization of advertising costs that would otherwise have been expensed. Once capitalized, these costs are then amortized over the period of future benefit.

The capitalization of direct-response advertising costs is an area of accounting that has seen significant abuse in the past. Consider, for example, the case of America Online, Inc. AOL capitalized most of the costs of acquiring new subscribers, a form of direct-response advertising. These costs included the costs of sending disks to potential customers – a ubiquitous piece of junk mail that millions received from the company in the 1990s. In 1996, at the behest of the SEC, the company took a special pretax charge of $385 million to write down its subscriber acquisition costs. According to the SEC, because the company operated in a new and evolving industry, it could not obtain persuasive historical evidence that would permit a reliable estimate of the future revenue that could be obtained from incremental advertising expenditures. Thus, capitalization was not appropriate. In another example, CUC International, Inc., a predecessor company to Cendant Corp., was found to be incorrectly capitalizing membership acquisition costs. In the late 1980s, a full decade prior to more celebrated problems at Cendant, CUC changed from a policy of capitalizing direct-response advertising costs to one of expensing them as incurred.

In a recent meeting of the Board, the FASB proposed that direct-response advertising costs should be expensed as incurred. The meeting in question was devoted primarily to the topic of

[1] http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819672534&blobheader=application%2Fpdf

revenue recognition. However, as part of that discussion, the topic of how to account for the costs of obtaining and setting up revenue-generating contracts, including direct-response advertising costs, were also discussed. The Board decided that all costs incurred in obtaining a contract, ". . . for example, the costs of selling and marketing, including direct-response advertising…" should be expensed.[1]

In our study, we look at companies who historically have capitalized direct-response advertising costs. To get a better understanding of what constitutes direct-response advertising costs and how those costs are accounted for, consider the cases of The Scotts Miracle-Gro Company and J Crew Group, Inc.

Scotts Miracle-Gro notes the following:

> "Scotts LawnService® promotes its service offerings primarily through direct mail campaigns. External costs associated with these campaigns that qualify as direct-response advertising costs are deferred and recognized as advertising expense in proportion to revenues over a period not beyond the end of the subsequent calendar year. Costs that do not qualify as direct-response advertising costs are expensed within the fiscal year incurred on a monthly basis in proportion to net sales."[2]

J. Crew discloses:

> "The costs associated with direct-response advertising, which consist primarily of catalog production and mailing costs, are capitalized and amortized over the expected future revenue stream of the catalog mailings, which we currently estimate to be approximately two months. The expected future revenue stream is determined based on historical revenue trends developed over an extended period of time. If the current revenue streams were to diverge from the expected trend, our amortization of deferred catalog costs would be adjusted accordingly."[3]

Other companies in our sample offered similar disclosures. Note that direct-response advertising costs are not general advertising costs but are more typically related to direct-mail advertisements, including direct-mail pieces, coupons and catalogs. The costs of such advertising campaigns can be readily linked to the revenues they generate. It is also worth noting that the time period over which companies amortize direct-response advertising costs is usually quite short, sometimes as little as four to six weeks, but can range up to as long as three years. Most companies amortize their direct-response advertising costs over periods of twelve

[1] Minutes of the February 3, 2010, Board Meeting: Revenue Recognition. Date: March 2, 2010. The Exposure Draft for a proposed accounting standard, *Revenue Recognition*, issued June 24, 2010, also calls for the expensing of all advertising costs, including direct-response advertising.
[2] Scotts Miracle-Gro Co. Form 10-K, Annual Report to the Securities and Exchange Commission, September 30, 2009, p. 70.
[3] J Crew Group Inc. Form 10-K, Annual Report to the Securities and Exchange Commission, January 30, 2010, p. 37.

months or less. Such short amortization periods could mute the financial statement impact of a change to expensing the costs as incurred.

The purpose of this study is to determine the effects of proposed changes to the accounting for direct-response advertising on the financial statements of a broad sample of companies.

Design

We obtained our sample of companies by screening the EDGAR database using various search term combinations containing "direct-response advertising." Due to the timing of our research, the majority of companies included in our sample had already filed a 10-K for 2009. However, a few of the companies had not yet filed, and so figures were obtained from 2008 annual 10-K filings. Regardless, it should be noted that all figures are the most recent figures available and should have no bearing on our analysis and/or conclusions reached.

Our final sample size included a total of twenty five companies. It should also be noted that our screening initially contained a number of companies who were identified based upon the fact that they currently expense direct-response advertising costs. A few examples are mentioned below:

Medco Health Solutions Inc. discloses:

> "SG&A also includes direct-response advertising expenses associated with PolyMedica, which are expensed as incurred."[1]

Mandalay Media Inc. discloses:

> "The Company expenses the production costs of advertising, including direct-response advertising, the first time the advertising takes place. Direct-response advertising is expensed immediately since there is a very limited ongoing return."[2]

Finally, Findex Com Inc. discloses:

> "Advertising costs, including direct-response advertising costs, are charged to operations as incurred. We have determined that direct-response advertising costs are insignificant."[3]

From our final sample we began our analysis by collecting several figures from both the balance sheet and income statement. From the balance sheet we collected total assets, shareholders' equity, and capitalized direct-response advertising. From the income statement we collected pre-tax income and the net change in capitalized direct-response advertising. Capitalized direct-

---

[1] Medco Health Solutions Inc. Form 10-K, Annual Report to the Securities and Exchange Commission, February 23, 2010, p. 43.
[2] Mandalay Media Inc. Form 10-K, Annual Report to the Securities and Exchange Commission, July 14, 2009, p. F-14.
[3] Findex Com Inc. Form 10-K, Annual Report to the Securities and Exchange Commission, April 7, 2010, p. F-11

response advertising amounts were typically found in the footnotes to the financial statements. The net change in capitalized direct-response advertising was calculated using the difference between the beginning and ending balances in the capitalized direct-response advertising account. The net change, which represents the effect of capitalization and amortization on pre-tax income, is the net difference between the amount capitalized and the amount amortized in one year.

Regarding the balance sheet, our objective was to gain an understanding of the effects of capitalization of direct-response advertising costs on total assets and shareholders' equity. In doing so, we were able to determine the significance of these capitalized costs as they relate to the balance sheet and measure how both asset and equity accounts would be impacted if these costs were not capitalized. Put simply, without a policy of capitalizing direct-response advertising, total assets and shareholders' equity would be reduced by the net capitalized amount, though the impact on shareholders' equity would be net of income taxes.

Regarding the income statement, our objective was to analyze the effects that a policy of direct-response advertising capitalization has on pre-tax income compared to a policy of expensing these costs as incurred. To do so, we adjusted reported pre-tax income for the net change in capitalized direct-response advertising amounts. This net change best reflects the effects of capitalizing versus expensing due to the fact that capitalization raises pre-tax income by deferring the related costs, while amortization lowers pre-tax income by writing off these costs over the life of the asset. Our focus with the income statement was to determine the significance of capitalization on pre-tax earnings. We adjusted reported pre-tax income and determined the overall percentage change in this figure.

Results

Prior to discussing the results to this study, it should again be mentioned that nearly all of the sample companies had an amortization period of less than twelve months. The impact of such a short amortization period is that basically all of a company's capitalized direct-response advertisings costs are written off or amortized within a calendar year. As such, the effects on pre-tax income can be limited.

Income Statement

The adjustments made to pre-tax income are provided in Table 1. The items presented include reported pre-tax income, net change in capitalized direct-response advertising, adjusted pre-tax income, and percentage (%) change in pre-tax income. All amounts are in thousands.

Table 1: The Effects on Pre-Tax Income of Capitalization of Direct-response Advertising Costs (Amounts in $ Thousands).

Company	Ticker	Reported Pre-tax Income (Loss)	Net Change, Inc (Dec), in Direct-Response Advertising	Adjusted Pre-tax Income	% Change
Acco Brands Corp	ABD	(246,000)	(700.0)	(245,300)	0.28%
Aerogrow International Inc.	AERO	(10,314)	(157.7)	(10,156)	1.53%
American International Group	AIG	(13,648,000)	(433,000.0)	(13,215,000)	3.17%
Brown Shoe Company Inc.	BWS	(188,606)	(300.0)	(188,306)	0.16%
Casual Male Retail Group	CMRG	(79,416)	(1,500.0)	(77,916)	1.89%
Cross Country Healthcare Inc	CCRN	(204,168)	217.0	(204,385)	-0.11%
Dynamic Response Group Inc.	DRGZ	(3,843)	653.0	(4,496)	-16.99%
EBHI Holdings Inc.	EBHIQ	(161,462)	(2,154.0)	(159,308)	1.33%
Ennis Inc.	EBF	(13,059)	178.0	(13,237)	-1.36%
Franklin Covey Co	FC	(14,461)	(400.0)	(14,061)	2.77%
Frederick's of Hollywood Group	FOH	(33,915)	(546.0)	(33,369)	1.61%
Genesco Inc.	GCO	253,782	(200.0)	253,982	0.08%
Gymboree Corp	GYMB	149,639	200.0	149,439	-0.13%
Imergent Inc.(1)	IIG	1,968	716.0	1,252	-36.38%
Intersections Inc	INTX	(10,418)	5,200.0	(15,618)	-49.91%
J C Penney Co Inc	JCP	910,000	(6,000.0)	916,000	0.66%
J Crew Group Inc	JCG	71,582	389.0	71,193	-0.54%
Limited Brands Inc.	LTD	453,000	(6,000.0)	459,000	1.32%
Nutri System Inc	NTRI	79,999	(15.0)	80,014	0.02%
Owens & Minor Inc/VA/	OMI	188,247	(13,937.0)	202,184	7.40%
Scotts Miracle-Gro	SMG	210,700	(2,400.0)	213,100	1.14%
Select Comfort Corp.	SCSS	14,690	1,100.0	13,590	-7.49%
Staples Inc.	SPLS	1,155,894	(1,800.0)	1,157,694	0.16%
Starbucks Corp.	SBUX	559,200	(1,600.0)	560,800	0.29%
Thermo Fisher Scientific	TMO	927,100	(7,100.0)	934,200	0.77%
				Average	-3.53%

(1) Due to fiscal year change, results are for six months ended December 31, 2009

In reviewing the results, it should be noted that many companies saw a declining balance in capitalized direct-response advertising. A decline in the balance indicates that current year amortization exceeded new amounts capitalized. As such, adjusted pre-tax income is higher or adjusted pre-tax loss is lower than the reported amount. With some companies experiencing increases in adjusted pre-tax income and some seeing declines, the average percentage change in pre-tax income is not very telling. Across the sample companies, however, the effects of capitalization and amortization on pre-tax income are wide ranging.

Specifically, the following companies had substantial decreases in adjusted pre-tax income:

Dynamic Response Group Inc. (12/31/08) (-16.99%)
Imergent Inc. (12/31/09) (-36.38%)
Intersections Inc. (12/31/09) (-49.91%)
Select Comfort Corp. (01/02/10) (-7.49%)

The following companies posted increases in adjusted pre-tax income greater than two percent:

American International Group (3.17%)
Franklin Covey Co. (08/31/09) (2.77%)
Owens & Minor Inc. (12/31/09) (7.40%)

Balance Sheet

The analysis related to the balance sheet can be seen in Table 2. The items presented include capitalized direct-response advertising, total assets, and total shareholders' equity. We also include calculations showing the amount of capitalized direct-response advertising as a percentage of both total assets and shareholders' equity (tax-effected using the 35% federal tax rate).

Again, at 2.26% and 3.17%, as a percentage of total assets and shareholders' equity, respectively, the averages for the sample are not compelling. However, direct-response advertising costs were a significant percentage of total assets for the following companies:

Dynamic Response Group Inc. (12/31/08) (21.05%)
Intersections Inc. (12/31/09) (21.65%)

Additionally, the following companies had capitalized direct-response advertising costs (net of taxes) that were five percent or more of shareholders' equity:

EBHI Holdings Inc. (01/03/09) (6.96%)
Frederick's of Hollywood Group (7/25/09) (18.17%)
Intersections Inc. (12/31/09) (28.05%)
Select Comfort Corp. (01/02/10) (5.21%)

Table 2: The Effects on Total Assets and Shareholders' Equity of Capitalized Direct-response Advertising Costs (Amounts in $ Thousands).

Company Name	Ticker	Capitalized Direct-response Advertising	Total Assets	Shareholder's Equity	DRA as % of Total Assets	DRA as % of Shareholder's Equity (net of tax)
Acco Brands Corp	ABD	1,000	1,282,200	(3,400)	0.08%	NM
Aerogrow International Inc.	AERO	346	14,609	(4,232)	2.37%	NM
American International Group	AIG	207,000	847,585,000	69,824,000	0.02%	0.19%
Brown Shoe Company Inc.	BWS	900	1,026,031	394,104	0.09%	0.15%
Casual Male Retail Group	CMRG	1,400	201,231	71,831	0.70%	1.27%
Cross Country Healthcare Inc	CCRN	1,553	425,849	234,023	0.36%	0.43%
Dynamic Response Group Inc.	DRGZ	839	3,988	(5,305)	21.05%	NM
EBHI Holdings Inc.	EBHIQ	7,795	596,920	72,810	1.31%	6.96%
Ennis Inc.	EBF	409	436,380	292,006	0.09%	0.09%
Franklin Covey Co	FC	100	143,878	69,004	0.07%	0.09%
Frederick's of Hollywood Group	FOH	1,751	77,637	6,265	2.26%	18.17%
Genesco Inc.	GCO	1,200	818,027	446,934	0.15%	0.17%
Gymboree Corp	GYMB	200	520,581	334,275	0.04%	0.04%
Imergent Inc.	IIG	1,267	56,442	25,982	2.24%	3.17%
Intersections Inc	INTX	41,600	192,171	96,407	21.65%	28.05%
J C Penney Co Inc	JCP	35,000	12,011,000	4,155,000	0.29%	0.55%
J Crew Group Inc	JCG	7,996	535,596	140,322	1.49%	3.70%
Limited Brands Inc.	LTD	27,000	6,972,000	1,874,000	0.39%	0.94%
Nutri System Inc	NTRI	0	159,471	115,825	0.00%	0.00%
Owens & Minor Inc/VA/	OMI	0	1,747,088	769,179	0.00%	0.00%
Scotts Miracle-Gro	SMG	2,100	2,220,100	584,500	0.09%	0.23%
Select Comfort Corp.	SCSS	1,800	118,240	22,458	1.52%	5.21%
Staples Inc.	SPLS	21,600	13,717,334	6,854,940	0.16%	0.20%
Starbucks Corp.	SBUX	7,200	5,576,800	3,045,700	0.13%	0.15%
Thermo Fisher Scientific	TMO	6,300	21,625,000	15,430,900	0.03%	0.03%
*Note DRA refers to Capitalized Direct-response Advertising					**Average**	**Average**
*Note "NM" refers to Not Meaningful for purposes of analysis					2.26%	3.17%

Financial Leverage

A final aspect we wanted to consider was the impact that a policy of capitalizing direct-response advertising costs may have on financial leverage. To begin, we calculated an initial leverage ratio consisting of liabilities to shareholders' equity. Reported liabilities were calculated by subtracting reported shareholders' equity from reported total assets. We then calculated a revised shareholders' equity figure by subtracting the capitalized direct-response advertising balance (net of 35% tax rate) from the reported shareholders' equity figure. This allowed us to calculate a revised leverage ratio that eliminated the effects of capitalization. Our results are presented in Table 3.

Table 3: The Effects of Capitalization of Direct-response Advertising Costs on Financial Leverage (Amounts in $ Thousands).

Company Name	Ticker	Capitalized Direct-response Advertising	Shareholder's Equity	Revised Shareholders' Equity	Total Liabilities	Total Liab./Shareholders' Equity	Total Liab./Revised Shareholders' Equity
Acco Brands Corp	ABD	1,000	(3,400)	(4,050.00)	1,285,600	NM	NM
Aerogrow International Inc.	AERO	346	(4,232)	(4,456.61)	18,841	NM	NM
American International Group	AIG	207,000	69,824,000	69,689,450.00	777,761,000	11.14	11.16
Brown Shoe Company Inc.	BWS	900	394,104	393,519.00	631,927	1.60	1.61
Casual Male Retail Group	CMRG	1,400	71,831	70,921.00	129,400	1.80	1.82
Cross Country Healthcare Inc	CCRN	1,553	234,023	233,013.66	191,826	0.82	0.82
Dynamic Response Group Inc.	DRGZ	839	(5,305)	(5,850.73)	9,293	NM	NM
EBHI Holdings Inc.	EBHIQ	7,795	72,810	67,743.25	524,110	7.20	7.74
Ennis Inc.	EBF	409	292,006	291,740.15	144,374	0.49	0.49
Franklin Covey Co	FC	100	69,004	68,939.00	74,874	1.09	1.09
Frederick's of Hollywood Group	FOH	1,751	6,265	5,126.85	71,372	11.39	13.92
Genesco Inc.	GCO	1,200	446,934	446,154.00	371,093	0.83	0.83
Gymboree Corp	GYMB	200	334,275	334,145.00	186,306	0.56	0.56
Imergent Inc.	IIG	1,267	25,982	25,158.45	30,460	1.17	1.21
Intersections Inc	INTX	41,600	96,407	69,367.00	95,764	0.99	1.38
J C Penney Co Inc	JCP	35,000	4,155,000	4,132,250.00	7,856,000	1.89	1.90
J Crew Group Inc	JCG	7,996	140,322	135,124.60	395,274	2.82	2.93
Limited Brands Inc.	LTD	27,000	1,874,000	1,856,450.00	5,098,000	2.72	2.75
Nutri System Inc	NTRI	0	115,825	115,825.00	43,646	0.38	0.38
Owens & Minor Inc/VA/	OMI	0	769,179	769,179.00	977,909	1.27	1.27
Scotts Miracle-Gro	SMG	2,100	584,500	583,135.00	1,635,600	2.80	2.80
Select Comfort Corp.	SCSS	1,800	22,458	21,288.00	95,782	4.26	4.50
Staples Inc.	SPLS	21,600	6,854,940	6,840,900.00	6,862,394	1.00	1.00
Starbucks Corp.	SBUX	7,200	3,045,700	3,041,020.00	2,531,100	0.83	0.83
Thermo Fisher Scientific	TMO	6,300	15,430,900	15,426,805.00	6,194,100	0.40	0.40
*Note DRA refers to Capitalized Direct-response Advertising						**Average**	**Average**
*Note "NM" refers to Not Meaningful for purposes of analysis						2.61	2.79

A quick comparison of the initial and revised leverage ratios indicates that a policy of capitalizing direct-response advertising costs does not have a significant effect on financial leverage. It should be noted that a total of three companies in our sample had negative balances in both shareholders' equity and revised shareholders' equity. These figures were not included in the calculation of the averages and were indicated with "NM," referring to not meaningful for purposes of analysis.

Two companies, Intersections, Inc. and Frederick's of Hollywood Group, saw meaningful increases in financial leverage as a result of expensing direct-response advertising costs. In the case of Intersections, financial leverage or liabilities to shareholders' equity, increased to 1.38 from .99, an increase of 39%. For Fredericks, financial leverage increased to 13.92 from 11.39, an increase of 22%.

Conclusion

In conclusion, our study examined the potential effects of proposed changes to the manner in which companies account for the costs of direct-response advertising. We included a total of twenty-five companies in our sample and used information given in both the 2009 (when available) and 2008 10-K filings. For each company, we collected the following information: total assets, total shareholders' equity, capitalized direct-response advertising, pre-tax income, and net change in capitalized direct-response advertising.

After obtaining these figures, we calculated capitalized direct-response advertising both as a percentage of total assets and, once tax-effected, as a percentage of total shareholders' equity. To look at the effects capitalized direct-response advertising has on the income statement, we adjusted reported pre-tax income for the net change in this capitalized amount.

Our findings were in line with our expectations going into the study. We expected that the effects for most companies would be minimal. We found that as a result of capitalization, companies did not hold an extremely high percentage of total assets on their balance sheets in the form of direct-response advertising costs. On average, capitalized direct-response advertising amounted to 2.26% of total assets. However, it should be noted that two companies held over twenty percent of their total assets in the form of capitalized direct-response advertising costs.

As a percentage of shareholders' equity, capitalized direct-response advertising was on average 3.17%, with a total of four companies holding over 5% of shareholders' equity in this form. Additionally, we also calculated a revised shareholders' equity figure that subtracted from reported shareholders' equity the net capitalized direct-response advertising balance, net of tax. This allowed us to also calculate a new leverage ratio based on the revised figure, which showed the effects of a policy of cost capitalization. The effects on financial leverage were minimal for most firms, though two firms saw increases in financial leverage of over 20%.

Regarding the income statement, we calculated an adjusted pre-tax income figure to determine the effects of capitalization on pre-tax earnings. We found there were both increases and decreases to pre-tax income, some of which were substantial. There were a total of three significant decreases, each exceeding 15%. Regarding positive increases to pre-tax income, the most significant increase was 7.40%, while most other increases were minimal.

Investors will want to be apprised of these findings as the FASB proceeds to a final statement on the expensing of direct-response advertising costs. While any standard change will have no effect on operating or free cash flow, depending on the firm, the effects on earnings, shareholders' equity, and measures of financial leverage could be significant.

